**Congressional Oversight Panel**

**Hearing**

# "Executive Pay Restrictions for TARP Recipients: An Assessment"

**Testimony of**


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## *I. Introduction and Summary*

Between October 2008 and December 2009, the U.S. Government invested nearly $400 billion into financial services and automotive firms through the Troubled Asset Relief Program (TARP), established under the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA). As a consequence of these cash infusions – typically made in the form of investments in preferred stock and warrants – U.S. taxpayers became major stakeholders in hundreds of bailed-out organizations, and were legitimately concerned that the interests of the executives of these organizations be aligned with those of taxpayers. Section 111 of EESA (as amended), imposed significant restrictions on executive pay for TARP recipients. The Act delegated to the U.S. Treasury the task of interpreting the details and implementing the pay restrictions; Treasury in turn established the Office of the Special Master of Compensation to address these issues.

I have been asked to provide my opinion on several issues related to the executive pay restrictions under the EESA (as amended), including:

1. *What was the intent of the legislation?*
2. *Did Treasury's regulations provide the Special Master with the appropriate guidance to achieve that purpose?*
3. *Were the Special Master's compensation determinations generally consistent with the intent of the statutory and regulatory authorities and the goals of the TARP?*
4. *Was the Special Master's "Public Interest Standard" the appropriate analytical framework for his compensation determinations?*
5. *Did the Special Master strike the appropriate balance between prohibiting excessive compensation and permitting the appropriate competitive compensation necessary to attract talented executives capable of maximizing shareholder value?*
6. *Did the determinations effectively discourage excessive risk-taking by executives?*

7. *Did the determinations provide any incentives for executives to make decisions that were not in the best interest of taxpayers, for example, prolonging a company's dependence on the government rather than taking it into bankruptcy?*
8. *What is your general view of the role of government in regulating executive compensation at financial institutions?*
9. *What lessons from the TARP experience with regulating executive compensation might be applicable to all financial institutions?*
10. *Are the Special Master's determinations a useful model for corporate executive compensation structures in the future?*
11. *Is there any evidence that the Special Master's determinations have been adopted by companies that were not subject to his oversight?*

I provide detailed responses to each of these questions in Section III below. Several themes and conclusions emerge from my responses, summarized briefly as follows:

- The apparent intent of the pay restrictions in EESA was to punish executives and companies perceived as being responsible for the financial crisis and to upend the Wall Street bonus culture, and not to protect taxpayers or to maximize the return on taxpayers' investments.

- While ostensibly designed to implement the EESA restrictions, Treasury's Interim Final Rule (IRM) "blended" the EESA restrictions with the more-sensible restrictions proposed earlier by the Obama administration (but rejected by Congress).

- In particular, Treasury circumvented the intentions of Congress by allowing salaries to be paid in the form of non-transferable stock, and by imposing more severe pay restrictions on firms requiring exceptional government assistance. These changes benefited taxpayers (relative to strict adherence to EESA).

- The Special Master – guided by an ill-defined "Public Interest Standard" – was forced to navigate between the conflicting demands of politicians (insisting on punishments) and taxpayer/shareholders (concerned with attracting, retaining, and motivating executives and employees).

- Ultimately, the most productive aspect of the restrictions was the pressure they put on TARP recipients to escape the restrictions by repaying the government sooner than most anticipated.

- In retrospect, the TARP experience is a case study in why the government should not get involved in regulating executive compensation.

My report proceeds as follows. Section II chronicles the evolution of the pay restrictions in the EESA (as amended), focusing on the restrictions in the original October 2008 legislation, the February 2009 Treasury guidance proposed by the Obama administration, the pay amendments introduced in conference as part of the February 2009 American Recovery and Reinvestment Act, and Treasury's interim final rule issued in June 2009. In addition, to provide context for this evolution I describe the "current events" influencing the evolving restrictions. In Section III, I offer my detailed responses to each of the eleven questions. Finally, Section IV describes my qualifications and discusses my advisory role with the Office of the Special Master during 2009 through early 2010.

## *II. The Evolution of the EESA Pay Restrictions*

### *Pay Restrictions in the October 2008 Bailout*

On September 19, 2008 – at the end of a tumultuous week on Wall Street that included the Lehman Brothers bankruptcy and the hastily arranged marriage of Bank of America and Merrill Lynch – Treasury Secretary Paulson asked Congress to approve the Administration's plan to use taxpayers' money to purchase "hundreds of billions" in illiquid assets from U.S. financial institutions.[1] Paulson's proposal contained no constraints on executive compensation, fearing that restrictions would discourage firms from selling potentially valuable assets to the government at relatively bargain prices.[2] Limiting executive pay, however, was a long-time top priority for Democrats and some Republican congressmen,

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1 Solomon and Paletta, "U.S. Bailout Plan Calms Markets, But Struggle Looms Over Details," *Wall Street Journal* (September 20, 2008), p. A1.

2 Hulse and Herszenhorn, "Bailout Plan Is Set; House Braces for Tough Vote," *New York Times* (September 29, 2008), p. 1.

who viewed the "Wall Street bonus culture" as a root cause of the financial crisis. Congress rejected the bailout bill on September 30, but reconsidered three days later after a record one-day point loss in the Dow Jones Industrial Average and strong bipartisan Senate support. The Emergency Economic Stabilization Act (EESA) was passed by Congress on October 3rd, and signed into law by President Bush on the same day.

The EESA enacted in October 2008 included what at the time seemed like serious restrictions on executive pay. For example, while Section 304 of the 2002 Sarbanes-Oxley Act required "clawbacks" of certain executive ill-gotten incentive payments, Sarbanes-Oxley only covered the chief executive officer (CEO) and chief financial officer (CFO), and only covered accounting restatements. While applying only to TARP recipients (Sarbanes-Oxley applied to all firms), the October 2008 EESA covered the top-five executives (and not just the CEO and CFO), and covered a much broader set of material inaccuracies in performance metrics. In addition, EESA lowered the cap on deductibility for the top-five executives from $1 million to $500,000, and applied this limit to all forms of compensation (and not just non-performance-based pay). EESA also prohibited new severance agreements for the top five executives, and limited payments under existing plans to 300% of the executives' average taxable compensation over the prior five years. When Treasury "invited" the first eight banks to participate in TARP (in some cases inducing reluctant participants), a critical hurdle involved getting the CEOs and other top executives to waive their rights under their existing compensation plans.

*Merrill Lynch bonuses fuel a growing controversy*

Congressional concern over executive compensation did not end with the October 2008 EESA enactment. Just three days after EESA was signed, congressional hearings on the failure of Lehman Brothers focused not on the firm's bankruptcy but rather on the compensation of Lehman's CEO.[3] By late October, Congress was demanding new and more-stringent limits on executive compensation at the bailed-out firms.[4]

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[3] Sorkin, "If This Won't Kill The Bonus, What Will?," *New York Times* (October 7, 2008), p. 1.

[4] Crittenden, "U.S. News: Lawmakers Want Strings Attached," *Wall Street Journal* (October 31, 2008), p. A4.

A major flash point came in early 2009 when it was revealed the Merrill Lynch had paid $3.6 billion in bonuses to its 36,000 employees just ahead of its acquisition by Bank of America.[5] The top 14 bonus recipients received a combined $250 million, while the top 149 received $858 million (Cuomo (2009)). The CEOs of Bank of America and the former Merrill Lynch (neither of whom received a bonus for 2008) were quickly hauled before Congressional panels outraged by the payments, and the Attorney General of New York launched an investigation to determine if shareholders voting on the merger were misled about both the bonuses and Merrill's true financial condition.

By the time the Merrill Lynch bonuses were revealed, the U.S. had a new President, a new administration, and new political resolve to punish the executives in the companies perceived to be responsible for the global meltdown. Indicative of the mood in Washington, Senator McCaskill (D-Missouri) introduced a bill in January 2009 that would limit total compensation for executives at bailed-out firms to $400,000, calling Wall Street executives "a bunch of idiots" who were "kicking sand in the face of the American taxpayer."[6]

*The Obama Proposal to amend EESA*

On February 4, 2009, President Obama's administration responded with its own proposal for executive-pay restrictions that distinguished between failing firms requiring "exceptional assistance" and relatively healthy firms participating in TARP's Capital Purchase Program. Most importantly, the Obama Proposal for exceptional assistance firms (which specifically identified AIG, Bank of America, and Citigroup) capped annual compensation for senior executives to $500,000, except for restricted stock awards (which were not limited, but could not be sold until the government was repaid in full, with interest). In addition, for exceptional-assistance firms the number of executives subject to "clawback" provisions would be increased from 5 under EESA to 20, and the number of executives with prohibited golden parachutes would be increased from 5 to 10; in addition, the next 25 would be prohibited from parachute payments that exceed one year's compensation).

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[5] Bray, "Crisis on Wall Street: Merrill Gave $1 Million Each to 700 Of Its Staff," *Wall Street Journal* (February 12, 2009), p. C3.

[6] Andrews and Bajaj, "Amid Fury, U.S. Is Set to Curb Executives' Pay After Bailouts," *New York Times* (February 4, 2009), p. 1.

Moreover – in response to reports of office renovations at Merrill Lynch, corporate jet orders by Citigroup, and corporate retreats by AIG – the Obama Proposal stipulated that all TARP recipients adopt formal policies on "luxury expenditures." Finally, the Obama Proposal required all TARP recipients to fully disclose their compensation policies and allow nonbinding "Say on Pay" shareholder resolutions.[7]

*Congress ignores Obama and expands restrictions on pay*

In mid-February 2009, separate bills proposing amendments to EESA had been passed by both the House and Senate, and it was up to a small "conference" committee to propose a compromise set of amendments that could be passed in both chambers. On February 13th – as a last-minute addition to the amendments – the conference chairman (Senator Chris Dodd) inserted a new section imposing restrictions on executive compensation that were opposed by the Obama administration and severe relative to both the limitations in the October 2008 version and the February 2009 Obama Proposal. Nonetheless, the compromise was quickly passed in both chambers with little debate and signed into law as the American Recovery and Reinvestment Act of 2009 by President Obama on February 17, 2009.

Table 1 compares the pay restrictions under the original 2008 EESA bill, the 2009 Obama Proposal, and the 2009 ARRA (which amended Section 111 of the 2008 EESA). While the "clawback" provisions under the original EESA covered only the top five executives (up from only two in SOX), the "Dodd amendments" extended these provisions to 25 executives and applied them retroactively.[8] In addition, while the original EESA disallowed severance payments in excess of 300% of base pay for the top five executives, the Dodd amendments covered the top 10 executives and disallowed *all* payments (not just amounts exceeding 300% of base). Most importantly, the Dodd Amendments allowed only two types of compensation: base salaries (which were not restricted in magnitude), and

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[7] TARP recipients not considered "exceptional assistance" firms could waive the disclosure and "Say on Pay" requirements, but would then be subject to the $500,000 limit on compensation (excluding restricted stock).

[8] The number of executives covered by the Dodd Amendments varied by the size of the TARP bailout, with the maximum number effective for TARP investments exceeding $500 million. As a point of reference, the average TARP firm among the original eight recipient received an average of $20 *billion* in funding, and virtually all the outrage over banking bonuses have involved banks taking well over $500 million in government funds. Therefore, I report results assuming that firms are in the top group of recipients.

**Table 1**

**Comparison of Pay Restrictions in EESA (Oct 2008), Obama Proposal (2009), and ARRA (2009)**

| | |
|---|---|
| | *A. Limits on Pay Levels and Deductibility* |
| Pre-EESA<br>(IRS §162(m) (1994)) | Limits deductibility of top-5 executive pay to $1,000,000, with exceptions for performance-based pay |
| EESA (2008)<br>All TARP Recipients | Limits deductibility of top-5 executive pay to $500,000, with no exceptions for performance-based pay |
| Obama (2009)<br>Exceptional Assistance Firms | In addition to deductibility limits, cash pay is capped at $500,000; additional amounts can be paid in restricted shares vesting after government paid back |
| Obama (2009)<br>Other TARP Recipients | Same as exceptional assistance firms, but pay caps can be "waived" if firm offers full disclosure of pay policies and a non-binding "say on pay" vote |
| ARRA (2009)<br>All TARP Recipients | In addition to deductibility limits, disallows all incentive payments, except for restricted stock capped at no more than one-half base salary. No caps on salary. |
| | *B. Golden Parachutes* |
| Pre-EESA<br>(IRS §280G (1986) | Tax penalties for change-in-control-related payments exceeding 3 times base pay |
| EESA (2008)<br>Auction Program | No new severance agreements for Top 5 |
| EESA (2008)<br>Capital Purchase Program | No new severance agreements for Top 5, and no payments for top 5 executives under existing plans exceeding 3 times base pay |
| Obama (2009)<br>Exceptional Assistance Firms | No payments for Top 10; next 25 limited to 1 times base pay |
| Obama (2009)<br>Other TARP Recipients | No payments for top 5 executives under existing plans exceeding 1 times base pay |
| ARRA (2009)<br>All TARP Recipients | No payments for Top 10<br>Disallows all payments (not just "excess" payments) |
| | *C. Clawbacks* |
| Pre-EESA<br>(Sarbanes-Oxley (2002)) | Covers CEO and CFO of publicly traded firms following restatements |
| EESA (2008)<br>Auction Program | No new provisions |
| EESA (2008)<br>Capital Purchase Program | Top 5 executives, applies to public and private firms, not exclusively triggered by restatement, no limits on recovery period, covers broad material inaccuracies (not just accounting restatements) |
| Obama (2009)<br>All TARP Recipients | Same as above, but covers 20 executives |
| ARRA (2009)<br>All TARP Recipients | Covers 25 executives for all TARP participants, retroactively |

restricted stock (limited to grant-date values no more than half of base salaries). The forms of compensation explicitly prohibited under the Dodd amendments for TARP recipients include performance-based bonuses, retention bonuses, signing bonuses, severance pay, and all forms of stock options. Finally, the Dodd amendments imposed mandatory "Say on Pay" resolutions for all TARP recipients.

*Treasury "blends" EESA with the Obama Proposal*

The Dodd amendments were signed into law as part of the amended EESA with the understanding that Treasury "shall promulgate regulations" to implement the amended compensation restrictions. In June 2009, Treasury issued its Interim Final Rule (IFR), along with the simultaneous creation of the Office of the Special Master of Executive Compensation. Ultimately, Treasury's regulations attempted to blend the restrictions in the Dodd amendments with those in the Obama Proposal in two important dimensions: the composition of compensation and the distinction between failing firms requiring exceptional assistance and relatively healthy firms participating in TARP's generally available capital access programs.

In order to blend the EESA restrictions (allowing only base salaries without limitation and restricted stock limited to one-half of salaries) and the Obama proposal (in which cash compensation was limited to $500,000 with no limitation on restricted stock that must be held until taxpayers were repaid), Treasury introduced a new compensation component: salary paid in the form of stock ("salarized stock") which was vested immediately but subject to transferability restrictions.

In addition to introducing salarized stock, Treasury's IFR also resurrected the distinction in the Obama Proposal between firms requiring exceptional assistance from the USA government and relatively healthy firms participating in generally available capital access programs. While the newly established Special Master had interpretive authority potentially affecting all TARP recipients, the IFR gave him specific authority to set the level and structure of compensation for executives in the seven exceptional-assistance firms: Bank of America, Citigroup, AIG, General Motors, Chrysler, and the financing arms of GM and Chrysler. Specifically, the Special Master was charged with approving every dollar paid to

**Table 3**

**Changes in Pay Imposed by Treasury's Special Master for Firms Requiring "Exceptional Assistance"**

| Corporation | Percentage Change in Pay from 2008 Levels | | Percentage Change in Pay from 2007 Levels | | Number of Executives in Top 25 |
|---|---|---|---|---|---|
| | Cash | Total | Cash | Total | |
| AIG | -90.8% | -57.8% | -89.2% | -55.7% | 13 |
| Bank of America | -94.5% | -65.5% | -92.2% | -63.3% | 13 |
| Citigroup | -96.4% | -69.7% | -78.4% | -89.6% | 21 |
| General Motors | -31.0% | -24.7% | -46.0% | -16.9% | 20 |
| Chrysler | -17.9% | +24.2% | +14.0% | +72.3% | 25 |
| GMAC | -50.2% | -85.6% | -42.5% | -78.2% | 22 |
| Chrysler Financial | -29.9% | -56.0% | na | na | 22 |

Source: October 22 letters from Special Master to each company, available at the US Treasury website (www.treas.gov).

the top 25 highest-paid employees at each of these seven firms, and was charged with approving the structure of pay (but not necessarily the dollar amount) for the next 75 highest-paid employees.

Table 3 summarizes the compensation determinations for the top 25 executives made by the Special Master and announced in October 2009. Cash compensation at the three banks regulated by the Special Master were cut by an average of 94%, while total compensation was cut by an average of 64%.

## *III. Responses to Specific Questions*

*1. What was the intent of the legislation?*

When ARRA with the Dodd amendments was enacted in February 2009, Congress (and the general public) were angry at Wall Street and its bonus culture, and suspicious that this culture was a root cause of the financial crisis. By limiting compensation to uncapped base salaries coupled with modest amounts of restricted stock, the Dodd amendments completely upended the traditional Wall Street model of low base salaries coupled with high bonuses paid in a combination of cash, restricted stock, and stock options. One interpretation of the Congress's intentions was to punish the executives and firms alleged to be responsible for the crisis. More charitably, Congress may have decided that banking compensation was

sufficiently out of control that the only way to save Wall Street was to destroy its bonus culture. Whatever the intent, it is my opinion that the restrictions were misguided and not in the interest of taxpayers.

Once taxpayers became a major stakeholder in the TARP recipients (and especially in the seven recipients requiring "exceptional assistance"), the government arguably had a legitimate role in aligning the interests of executives with those of taxpayers. For example, compensation policies should clearly avoid providing incentives to take excessive risks with taxpayer money. More generally, one could imagine embracing an objective of "maximizing shareholder value while protecting taxpayers," or perhaps "maximizing taxpayer return on investment."

In return for the TARP investments, the government typically received a combination of preferred stock and warrants to purchase common equity at a pre-determined market price. Taxpayers therefore want executive compensation tied to the contractual dividend payments on (or repurchases of) the preferred stock and on the appreciation of the common stock. Most compensation consultants and practitioners working on behalf of taxpayers would have recommended low base salaries coupled with bonuses tied to company operating performance (likely based on cash flows available for preferred dividends) and stock options, restricted stock, and other plans tied to shareholder-value creation. Taxpayers would also want the ability to pay reasonable signing bonuses to attract executive talent into the company, and to pay reasonable severance to ease the transition of executives leaving the company. In contrast, the EESA (as amended) prohibited signing bonuses, incentive bonuses, severance bonuses, stock options, performance shares, and other components often found in well-designed compensation plans.

*2. Did Treasury's regulations provide the Special Master with the appropriate guidance to achieve that purpose?*

As discussed above, Treasury's regulations attempted to blend the restrictions in the Dodd amendments with those in the Obama Proposal. Under the EESA (as amended), compensation for TARP recipients could consist only of base salary and restricted stock, where salaries were unlimited and restricted stock was limited to be no more than one-half of

salary. Under the Obama Proposal, non-equity compensation (including salaries and bonuses) was limited to $500,000, and companies could issue an unlimited amount of restricted stock provided that the executive was precluded from selling the stock until after the TARP funds were repaid in full. Importantly, the limits under the Obama Proposal were only binding for firms deemed to require exceptional assistance (assuming that the other TARP recipients complied with the disclosure and say-on-pay provisions).

In order to blend these seemingly disparate provisions, Treasury's IFR introduced a new type of compensation not anticipated (and therefore not explicitly prohibited) by the EESA: salary paid in the form of stock (henceforth called "salarized stock"). Salarized stock differs from restricted stock in exactly one dimension: restricted stock is subject to forfeiture if the executive leaves the firm prior to vesting, while salarized stock vests immediately and is not subject to forfeiture. However, both salarized and restricted stock can be subject to transferability restrictions, such as prohibiting executives from selling stock received as salary until a certain date in the future or a pre-specified event (e.g., repayment of TARP funds). Treasury's regulations therefore made it possible for companies to follow the Obama prescription of $500,000 in base salary and the remainder in stock that the executive could not sell until TARP repayment (or other performance- or time-based contingencies).

In practice, the vesting of restricted stock is often accelerated upon retirement or termination without cause, and executives therefore forfeit their restricted shares only in relatively rare situations when they are fired for cause or resign voluntarily. Thus, the distinction between restricted and salarized stock is largely semantic or at least of second-order importance. Treasury's introduction of salarized stock therefore represents a significant circumvention of the Dodd amendments. In my opinion, it was also a brilliant circumvention, since it mitigated the single most-destructive restriction on pay for TARP recipients (i.e., the elimination of all incentive compensation beyond a limited amount of restricted stock).

In addition, also as discussed above, Treasury's regulations resurrected the Obama-proposal distinction between failing firms requiring exceptional assistance and relatively healthy firms participating in generally available capital access programs. In particular, while the pay restrictions in the Dodd amendments applied equally to all TARP recipients, the IFR

followed the Obama Proposal in placing harsher restrictions on the exceptional assistance firms.

The Treasury regulations virtually assured (perhaps inadvertently) that the Special Master's attention would be focused on the seven exceptional assistance firms and not on the broader population of TARP recipients. The IFR essentially required the Special Master to approve every dollar paid to a top 25 executive at each of the seven firms, as well as approving the structure of pay for the next 75 highest-paid employees at each of these firms. This task alone would require the full-time resources of a medium-size consulting firm. Working only with a small group of pro-bono attorneys and advisors and staff assigned from Treasury, it was not reasonable to expect the Special Master to devote commensurate time to the healthier TARP recipients. Indeed, the Special Master's preliminary audit of compensation for other TARP recipients was not even started until most of the TARP funds had been repaid in full.

*3. Were the Special Master's compensation determinations generally consistent with the intent of the statutory and regulatory authorities and the goals of the TARP?*

To my knowledge, the Special Master's compensation determinations were always consistent with Treasury's IFR. However, as noted above in my response to Question 2, the Treasury's regulations were significantly (but productively) inconsistent with EESA (as amended) in at least two dimensions: pay composition and exceptional assistance. In addition, as noted above in my response to Question 1, the pay restrictions in EESA (and, to a lesser-extent, in the IFR) were not generally consistent with the objective of protecting taxpayer investment in TARP.

*4. Was the Special Master's "Public Interest Standard" the appropriate analytical framework for his compensation determinations?*

An appropriate analytical framework for compensation design must begin with a well-specified objective function, such as "maximizing shareholder return while protecting taxpayer's interest" or "maximizing the return to taxpayers." Such objective functions often need to be considered in light of relevant constraints, such as the pay restrictions embedded in EESA. Explicitly specifying both the objective function and constraints allows the plan

designer to weigh tradeoffs of design elements such as the mix of salaries, restricted stock, and salarized stock, and the vesting or transferability restrictions on that stock.

In my opinion, the "public interest standard" is not an objective function, but a ill-defined concept that allows too much discretion and destroys accountability for those exercising the discretion. For example, applying the "public interest standard" allows Congress to limit compensation they perceive as excessive, without evidence or accountability for the consequences. Similarly, invoking the "public interest standard" forced the Special Master to navigate between the conflicting demands of politicians (insisting on punishments) and taxpayer/shareholders (concerned with attracting, retaining, and motivating executives and employees).

As an example of how the "public interest standard" can lead to punitive pay cuts, consider the case of Bank of America's Ken Lewis, who as recently as December 2008 was named American Banker's "Banker of the Year" for his firm's rescue of Merrill Lynch.[9] In October 2009, Mr. Lewis announced he would step down at the end of the year, and indicated that he would forego his 2009 bonus and the remainder of his 2009 salary. The Special Master decided that wasn't enough, and demanded that Mr. Lewis return *all* the salary already earned for services rendered the year, or risk a determination that Mr. Lewis' contractual pension benefits were contrary to the public interest (and therefore subject to renegoiation).[10] It is difficult to view this decision as anything other than punitive and a misuse of the "public interest standard," since Mr. Lewis clearly rendered services on behalf of Bank of America during 2009, and should clearly be compensated for that service.

*5. Did the Special Master strike the appropriate balance between prohibiting excessive compensation and permitting the appropriate competitive compensation necessary to attract talented executives capable of maximizing shareholder value?*

When executive compensation is described as "excessive" (or "inappropriate" or "unwarranted") the individual offering the description usually means one of three things. First, the term might refer to cases where compensation is determined not by competitive

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[9] Fitzpatrick and Scannell, "BofA Hit by Fine Over Merrill --- Bank Pays SEC $33 Million in Bonus Dispute; Sallie Krawcheck Hired in Shake-Up," *Wall Street Journal* (August 4, 2009), p. A1.

[10] Story, "Pay Czar Doubts Cuts Will Make Bankers Leave," *New York Times* (October 23, 2009), p. 8.

market forces but rather by captive board members catering to rent-seeking entrenched executives.[11] Second, the term might refer to concerns about the misallocation of resources, such as a belief that top executives shouldn't earn that much more than teachers because teachers are more important to society. Finally, although generally not acknowledged by the participants in these often frenzied debates, the term might reflect one of the least attractive aspects of human beings: jealousy and envy.

Without question, the highest-paid employees in financial services firms are paid more than their counterparts in other industries, driven largely by what has become known as the "Wall Street Bonus Culture." The heavy reliance on bonuses has been a defining feature of Wall Street compensation for decades, going back to the days when investment banks were privately held partnerships. Such firms kept fixed costs under control by keeping base salaries low and paying most of the compensation in the form of cash bonuses that varied with individual or company profitability. This basic structure of low salaries and high year-end distributions remained intact when the investment banks went public, but the cash bonuses were replaced with a combination of cash, restricted stock, and stock options. The rewards available to top performers have attracted the best and brightest college, MBA, and PhD graduates into financial services. While some might argue that it would be better to have the best and brightest graduates become doctors or public servants, a general advantage of a capitalist free-market economy is its propensity to move resources to higher-valued uses.

The fact that pay is *high* does not, however, imply that pay is *excessive* in the sense of not being determined by competitive market forces. Even the most vocal advocates of the view that powerful CEOs effectively set their own salaries rarely apply the view to executives and employees below the very top. The highest-paid employees in financial services firms typically have scarce and highly specialized skills that are specific to their industry but not necessarily to their employer. As a result, employees in financial services are remarkably mobile both domestically and internationally when compared to employees in virtually any other sector in the economy. When the Dodd amendments were enacted in February 2009, the entire global financial system was in crisis and there was a belief that pay

[11] See, for example, Bebchuk and Fried (2004a); Bebchuk and Fried (2004b); Bebchuk, et al. (2010); Bebchuk and Fried (2003); Bebchuk, et al. (2002); Fried (2008a); Fried (2008b); Fried (1998).

could be cut "across the board" since, after all, there was no where else for the employees to go. However, by the time the Special Master made his pay determinations in October 2009, the world had changed: most formerly constrained recipients had repaid their TARP obligations, were actively hiring and were competing with unconstrained hedge funds and private equity funds for top financial talent.

As evidence of the mobility of financial service executives, consider the following result from Table 3: of the 75 highest-paid executives in AIG, Bank of America, and Citigroup in 2008, only 47 (62%) had remained in their firms through October 2009 (and were thus subject to pay approval by the Special Master). While the 28 departures were not all "regretted resignations" (including several former Merrill Lynch traders and some resignations encouraged by the Special Master), the departures included several high-performing executives and traders. For example, Andrew J. Hall – the head of Citigroup's Phibro profitable energy-trading division – was set to receive $100 million in bonuses for 2009. Although Citigroup maintained that the bonus should be exempt from the Special Masters' scrutiny because it was based on a contract that pre-dated TARP, the Special Master contended that the contract could be voided because it promoted excessive risk taking and ran counter to the public interest.[12] To avoid the conflict, Citigroup sold the Phibro unit to Occidental Petroleum at approximately its book value, which in turn promptly (and happily) paid Mr. Hall his contractual bonus. The Phibro divestiture deprived taxpayers of approximately $400 million in annual net cash flow that would have been available to pay dividends or retire preferred stock.

*6. Did the determinations effectively discourage excessive risk-taking by executives?*

The EESA prohibits executive officers of TARP recipients from having incentives "to take unnecessary and excessive risks that threaten the value of the financial institution." While the IFR require compensation committees to "identify and limit the features" in pay plans that could lead executives to take excessive risks, the law stops short of defining "excessive risk" or providing guidance on how one might distinguish excessive risk from the normal risks inherent in all successful business ventures.

[12] Dash and Healy, "Citi Averts Clash Over Huge Bonus," *New York Times* (October 10, 2009), p. 1.

There are exactly two ways that bonuses – or incentive compensation more broadly – can create incentives for risk taking. The first way is through asymmetries in rewards for good performance and penalties for failure, as suggested by the title of the Cuomo (2009) Report ("The 'Heads I Win, Tails You Lose' Bank Bonus Culture"). When executives receive rewards for upside risk, but are not penalized for downside risk, they will naturally take greater risks than if they faced symmetric consequences in both directions. The classic example of asymmetries (or what economists call "convexities") in the pay-performance relation implicit in stock options, providing rewards for stock-price appreciation above the exercise price, but no penalties (below zero) for stock-price depreciation below the exercise price. Executives with options close to expiration that are out of the money have strong incentives to gamble with shareholder money; executives with options that are well in the money have fewer such incentives. Similarly, in cases of financial distress when stock prices are close to zero, executives paid a base salary and restricted stock also face asymmetric payouts and have incentives to gamble with taxpayer money, since stock prices are bounded by zero on the downside but are not limited on the upside.

The second way that incentive compensation can create incentives for risk taking is through performance measurement. For example, in the years leading up to its dramatic collapse and acquisition by JPMorgan Chase at fire-sale prices, Washington Mutual excelled at providing loans and home mortgages to individuals with risky credit profiles.[13] WaMu mortgage brokers were rewarded for writing loans with little or no verification of the borrowers assets or income, and received especially high commissions when selling more-profitable adjustable-rate (as opposed to fixed-rate) mortgages. The basic incentive problem at WaMu was a culture and reward system that paid people to write loans rather than to write "good loans" – that is, loans with a decent chance of actually being paid back. In the end, WaMu got what it paid for. Similar scenarios were being played out at Countrywide Finance, Wachovia, and scores of smaller lenders who collectively were not overly concerned about default risk as long as home prices kept increasing and as long as they could keep packaging and selling their loans to Wall Street. But, home prices could not continue to increase when prices were being artificially bid up by borrowers who could not realistically qualify for or

[13] The information in this paragraph is based on Goodman and Morgenson, "By Saying Yes, WaMu Built Empire on Shaky Loans," *New York Times* (December 27, 2008).

repay their loans. The record number of foreclosures in 2008, and the associated crash in home values, helped send the U.S. economy (and ultimately the global economy) into a tailspin.

In the current anti-banker environment, it has become fashionable to characterize plans such as those at Washington Mutual as promoting excessive risk taking. But, the problems with paying loan officers on the quantity rather than the quality of loans is conceptually identical to the well-known problem of paying a piece-rate worker based on the quantity rather than the quality of output, or the well-known problem of paying executives (or investment bankers) based on short-term rather than long-term results. Put simply, these are performance-measurement problems, not risk-taking problems, and characterizing them as the latter leads to impressions that the problems are somehow unique or more important in the banking sector, when in fact they are universal.

Under EESA (as amended), TARP recipients are allowed three forms of compensation: base salaries, salarized stock, and restricted stock. The relevant performance measures are shareholder return and any other measure that affect the transferability or vesting of the salarized or restricted stock. For TARP recipients with unusually depressed stock prices, the reliance on stock conceptually introduces asymmetries that can promote risk taking. However, these incentives are mitigated by the restrictions on transferability: since the executives cannot realize a gain on their stock until the government is partially or fully repaid, there are no opportunities to pursue a short-run gain at the expense of long-run performance.

Overall, the Special Master pay determinations neither encouraged nor discouraged excessive risk taking. In any case, the asymmetries in the rewards and punishments inherent in the determinations of current pay are trivial compared to those associated with large out-of-the-money option holdings, FDIC insurance, and "too big to fail" guarantees.

*7. Did the determinations provide any incentives for executives to make decisions that were not in the best interest of taxpayers, for example, prolonging a company's dependence on the government rather than taking it into bankruptcy?*

As discussed above, the pay restrictions in EESA (as amended) were not in the best interest of taxpayers and were not constructed with the objective of rewarding taxpayers' return on investment or rewarding shareholder return while protecting taxpayers. Given the pay restrictions in EESA (as interpreted by the IFR), the determinations by the Special Master in regards to the mix of salary and stock seem appropriate, while the determinations relating the overall level of pay made it difficult for the recipients of exceptional assistance to attract and retain qualified employees. However, I am not aware of any specific decisions made that were driven by the pay determinations and ran counter to the best interest of taxpayers.

One arguably positive aspect of the pay restrictions is that many TARP recipients found the EESA reforms sufficiently onerous that they hurried to pay back the government in time for year-end bonuses. I have heard expressed (but largely dismiss) a concern that such early repayment was not in the taxpayers' interest.

*8. What is your general view of the role of government in regulating executive compensation at financial institutions?*

Compensation practices in financial services can certainly be improved. For example, cash bonus plans in financial services can be improved by introducing and enforcing bonus banks or "clawback" provisions for recovery of rewards if and when there is future revision of critical indicators on which the rewards were based or received. Several banks, including Morgan Stanley, UBS, and Credit Suisse have introduced plans with clawback features over the past several months, and I applaud these plans as moves in the right direction.

Bonus plans in financial services can also be improved by ensuring that bonuses are based on value creation rather than on the volume of transactions without regard to the quality of transactions. Measuring value creation is inherently subjective, and such plans will necessarily involve discretionary payments based on subjective assessments of performance.

Compensation practices in financial services can undoubtedly be improved through government oversight focused on rewarding value creation and punishing value destruction. However, it is highly unlikely that compensation practices can be improved through increased government rules and regulations. Indeed, the reality is that executive pay *is* already heavily regulated, in both the financial sector and in other sectors. There are disclosure rules, tax policies, and accounting standards designed explicitly to address perceived abuses in executive compensation. There is also direct intervention, such as the prohibitions on option grants and incentive bonuses in bailed-out banks. Common to all existing and past attempts to regulate pay are important (and usually undesirable) unintended consequences. For example, the 1984 laws introduced to reduce golden parachute payments led to a proliferation of change-in-control arrangements, employment contracts, and tax gross-ups. Similarly, the 1993 deductibility cap on non-performance-related pay is generally credited with fueling the escalation in pay levels and option grants in the 1990s, and the enhanced disclosure of perquisites in the 1970s is generally credited with fueling an explosion in the breadth of benefits offered to executives.

The unintended consequences from regulation are not always negative. For example, reporting requirements in the 2002 Sarbanes-Oxley bill (in which executives receiving options had to report those options within 48 hours) are generally credited for stopping the unsavory practice of "option backdating," even though the authors of the bill had no idea the practice existed. As another example discussed above, the pay regulations imposed on banks accepting government bailouts had the arguably positive effect of getting investors paid back much more-quickly than anyone expected, in order to escape the regulations. Even the 1993 deductibility cap – which backfired in its attempt to slow the growth in CEO pay – had the positive effect of greatly increasing the alignment between CEOs and their shareholders. But, these positive effects are accidents and cannot be relied upon.

Thus, my strong recommendation is to resist calls for further government regulation, and indeed governments should re-examine the efficacy of policies already in place. Part of the problem is that regulation – even when well intended – inherently focuses on relatively narrow aspects of compensation (or narrow definitions of firms or industries) allowing plenty of scope for costly circumvention. An apt analogy is the Dutch boy using his fingers to plug

holes in a dike, only to see new leaks emerge. The only certainty with pay regulation is that new leaks will emerge in unsuspected places, and that the consequences will be both unintended and costly.

A larger part of the problem is that the regulation is often mis-intended. The regulations are inherently political and driven by political agendas, and politicians seldom embrace "creating shareholder value" (or, "taxpayer value") as their governing objective. While the pay controversies fueling calls for regulation have touched on legitimate issues concerning executive compensation, the most vocal critics of CEO pay (such as members of labor unions, disgruntled workers and politicians) have been uninvited guests to the table who have had no real stake in the companies being managed and no real interest in creating wealth for company shareholders. Indeed, a substantial force motivating such uninvited critics is one of the least attractive aspects of human beings: jealousy and envy. Although these aspects are never part of the explicit discussion and debate surrounding pay, they are important and impact how and why governments intervene into pay decisions.

*9. What lessons from the TARP experience with regulating executive compensation that might be applicable to all financial institutions?*

As of December 2009, there were approximately 700 unique financial institutions that had received TARP funds. Most of the recipients were small, private, or closely held, and were not significantly constrained by the EESA restrictions. Of the larger banks that were constrained, most had repaid the government in time to pay 2009 bonuses and stock options. Even among the seven "exceptional assistance" firms subject to enhanced scrutiny by the Special Master, the only two traditional banks (Bank of America and Citigroup) repaid the government in December 2009 and were no longer subject to the pay constraints.[14] Therefore, apart from the cost of early repayment, the pay restrictions were ultimately of little consequence to the vast majority of financial institutions receiving TARP funds, and thus there is little to learn from their experience.

[14] Citigroup became unconstrained when the government's investment was exchanged for transferable Citigroup common stock.

Nonetheless, the TARP experience has provided useful evidence on the challenges of regulating executive compensation in a wide variety of organizations (even within a relatively homogenous industry). Central to the regulation are prohibitions on excessive compensation and incentives to take excessive risk, both imposed without guidance (either from Congress or Treasury) on how to define or measure what is "excessive." The TARP experience also illustrates the danger of prohibiting certain forms of compensation (e.g., bonuses, severance pay, stock options) because of perceived abuses in isolated cases. Finally, the experience of the Office of the Special Master in closely regulating just seven companies hints at how costly (in terms of both time and resources) it would be to regulate an entire industry.

*10. Are the Special Master's determinations a useful model for corporate executive compensation structures in the future?*

In introducing salarized stock and distinguishing it from restricted stock, Treasury and the Special Master have broken the seemingly inextricable link between vesting and transferability. Traditionally, vesting has always referred to the date when the executive could not only keep the shares if he left the firm, but was also free to sell the shares on the open market. However, and aside from satisfying tax obligations, there is no obvious reason why we should allow executives to sell company shares at the same time they are no longer subject to forfeiture. Separating vesting and transferability is a brilliant idea, and one that I hope will gain traction in corporate boardrooms.

*11. Is there any evidence that the Special Master's determinations have been adopted by companies that were not subject to his oversight?*

"Connecting the dots" between the Special Master's determinations and practices in other firms is difficult, because in economic downturns we often see reductions in cash bonuses and stock options. Indeed, the most dramatic trends in executive compensation over the past decade has been a flattening of total compensation levels, and a reduction in the importance of stock options coupled with an increase in restricted stock – trends pre-dating but generally consistent with the Special Master's determinations. Overall, I am not aware

that the Special Master's determinations have been adopted by any companies that were not subject to his oversight.

### *IV. Author's Statement*

I am currently the Kenneth L. Trefftzs Chair in Finance at the University of Southern California Marshall School of Business. I have been a full professor of the Department of Finance and Business Economics at the USC Marshall School since 1995. In addition, I hold joint appointments in the USC School of Law (as Professor of Business and Law) and in the USC College of Letters, Arts, and Sciences (as Professor of Economics). I served as chair for the Marshall School's Department of Finance and Business Economics from 2003-2004, and as the Marshall School's Vice Dean of Faculty and Academic Affairs from 2004-2007. From 1991 to 1995, I was an Associate Professor of Business Administration at the Harvard Business School, and from 1983 to 1991, I was an Assistant and Associate Professor at the University of Rochester's William E. Simon Graduate School of Business Administration.

I received a Ph.D. in Economics from the University of Chicago in 1984, where my honors included a National Science Foundation Fellowship, Milton Friedman Fund Fellowship, and a Social Science Foundation Dissertation Fellowship. I also have an M.A. in Economics from the University of Chicago, and a B.A. degree (summa cum laude) from the University of California, Los Angeles. I am a member of Phi Beta Kappa, the American Economic Association, and the American Finance Association. I am an associate editor of the *Journal of Financial Economics* and the *Journal of Corporate Finance,* a former associate editor of the *Journal of Accounting and Economics*, and serve as referee to over thirty professional and academic journals. I am the former chairman of the Academic Research Committee of the American Compensation Association.

I am a recognized expert on executive compensation, and have written and published extensively on issues related to executive compensation. During 1992 and 1993, I conducted annual surveys of executive compensation practices in the 1,000 largest U.S. corporations. The surveys, sponsored by the United Shareholders Association, were used extensively by institutional investors and large shareholders in evaluating and comparing the effectiveness of compensation policies. I also advised the SEC in formulating their 1992 disclosure rules

for top management pay, and was a prominent member of the 1992 and 2003 National Association of Corporate Directors' Blue Ribbon Commissions on Executive Compensation, which issued reports calling for the overhaul of CEO pay practices.

I have written nearly fifty articles, cases, or book chapters relating to compensation and incentives in organizations. Results from my research on executive compensation have been widely cited in the press (including the *Wall Street Journal, New York Times*, *Washington Post*, *Los Angeles Times*, *Chicago Tribune*, *USA Today*, *Economist*, *Fortune*, *Forbes*, *Business Week*, and *Time*) and on national television (including CNN and CBS news). I have offered testimony relating to executive compensation to the U.S. House of Representatives, and given speeches and presentations on compensation and incentives to a variety of academic and practitioner audiences, including the Conference Board, the American Compensation Association, and the Board of Governors of the Federal Reserve.

My university teaching at USC, Harvard, and Rochester encompasses a wide variety of courses at the undergraduate, MBA, Ph.D., and executive levels. I have developed and taught undergraduate, MBA, and Ph.D. courses in compensation, incentives, human resource management, corporate finance (including mergers, acquisitions, and leveraged buyouts), and corporate governance.

I have testified as an expert witness in multiple proceedings in federal and state courts; my testimony has focused on virtually all aspects of compensation. I have consulted with organizations and conducted research on compensation and incentives in professional partnerships and corporations. I have consulted with, or given speeches to, top managers and compensation committees at several large corporations, including IBM, AT&T, Merck, Bristol-Myers-Squibb, Genzyme, Procter & Gamble, Philip Morris, General Motors, Prudential, and Chubb. I spent the 1994-1995 academic year on leave from Harvard as the Visiting Scholar and Consultant at Towers Perrin, a major benefits and compensation consulting firm, where my activities included making formal presentations and leading informal roundtable discussions on executive compensation to clients nationwide, as well as being involved in a variety of consulting engagements.

From July 2009 to January 2010, I served as an external advisor to the U.S. Treasury's Special Master of Executive Compensation. During this time, I participated in several conference calls or on-site meetings, and prepared several reports in response to specific questions related to the structure of compensation. I did not have access to confidential data provided by the companies, and never (to my knowledge) participated in calls that revealed such data. While I gave advice when asked (and often when not asked), I am not aware whether that advice was reflected in any ultimate determinations made by the Special Master. I neither requested nor received any compensation in return for my services.

I have not received any Federal grants or contracts (including subgrants or subcontracts) related to my testimony, and I am not representing any organization that has received such grants related to my testimony.

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